SEB FI & FX Strategy

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Higher yields mean fewer hikes?

At a glance:

In market focus. Earnings season; risk appetite; France; Middle East; growth and inflation indicators. Global macro and risk appetite. The past month has been brutal for global bond markets, driven mainly by policy repricing and compounded by the AI investment boom, which adds to supply pressures from government deficits and Eurosystem balance sheet reduction. To some extent, the same forces driving losses in rates markets are lifting expected equity returns. Standard expected-return models suggest bond yields are not yet high enough to eliminate the excess return offered by equities. However, if rates and credit spreads keep rising, they will eventually force companies investing in AI to scale back investment. That is the point at which rates become too high. We see the policy paths priced in the US and euro area as relatively hawkish, with scope for some softening in the coming months. This should help cap the upside in bond yields and support risk appetite.

US macro: Hot inflation. CPI inflation exceeded expectations for the second consecutive month in September, after mostly downside surprises over the past year and a half. The fact that increases were broadly based, in both goods and services, is another concern. Continued elevated energy prices have increased risks for indirect effects on other goods and services, through for instance more expensive transportation. A resilient economy, with strong demand from both the AI build-out and from wealthy consumers, increases those risks. We have raised our CPI forecast for 2026 and 2027 slightly. Wage inflation continues to slow, which implies that the upturn in inflation will be temporary.

USD short rates: October pause, but strong support for at least one more hike. Several Fed members have said they want to pause rate hikes in October to evaluate the effects of the September hike and to get more data. Tighter financial conditions due to rising yields are another reason to move cautiously, especially if equities were to come under pressure. With markets pricing in around 70bp of additional tightening by summer 2027, we see the balance of risks for rate trajectory as skewed to the downside.

USD bonds: Risk sentiment beginning to cap yields? Short-end Treasury yields rose in response to Wednesday's stronger-than-expected September CPI, while long bonds rallied as equities sold off. The price action suggests we may have reached the point where higher rates weigh on risk sentiment, in turn helping to cap the upside in yields. The coming days will be important in determining whether the move triggers a continued short-covering rally.

France: Budget concerns keep spreads wide. The wide French-German 10Y spread reflects persistent fiscal and political concerns. Prime minister Lecornu has presented a budget containing new savings of around EUR 43bn. The aim of reducing the deficit to 5% of GDP looks ambitious, even for 2027, particularly given the weak growth outlook. Lecornu's centrist government depends on either the far-right National Rally or the left-wing alliance to at least abstain in the budget vote (scheduled for 17 November). Next year's presidential election will add to the risks.

Euro area fragmentation risk: How will the ECB respond? Spillovers from France into broader markets have fuelled concerns, reviving memories of the 2010-12 euro crisis. The bar for ECB intervention remains

high unless contagion intensifies significantly, but the ECB has the tools to address fragmentation if needed. We outline the likely sequence of measures it could implement if the situation deteriorates.

EUR short rates: Significant shift in ECB communication. A chorus of Governing Council comments over the past 1-2 weeks suggests tighter financial conditions and higher yields may warrant fewer rate increases than would otherwise be needed. Forwards currently price in around 65bp of hikes by next autumn, down from 100bp as recently as 23-24 September. We think a further repricing to below 60bp could be warranted.

EUR bonds: Supported by softer ECB expectations. Policy rate expectations remain the key driver of the German 10Y yield. Scope for further softening in ECB pricing suggests the yield will trade near the lower end of our established 3.40-3.60% target range, potentially testing lower levels. However, we do not expect a sustained downtrend until the actual policy rate peak is closer.

EURUSD waiting for a catalyst: After falling from the 1.15–1.20 range that held through most of 2025–26, EURUSD has been hovering around 1.12 since the start of October. A break lower would need sticky US inflation, persistently high oil and a stalled France to keep widening the US-euro area rate gap. A break higher would need a trigger for covering of short EUR positions: progress on Iran, stabilisation in France, or a US equity selloff that reverses foreign inflows into US assets. Until one of these materialises, EURUSD is likely to stay range-bound around current levels.

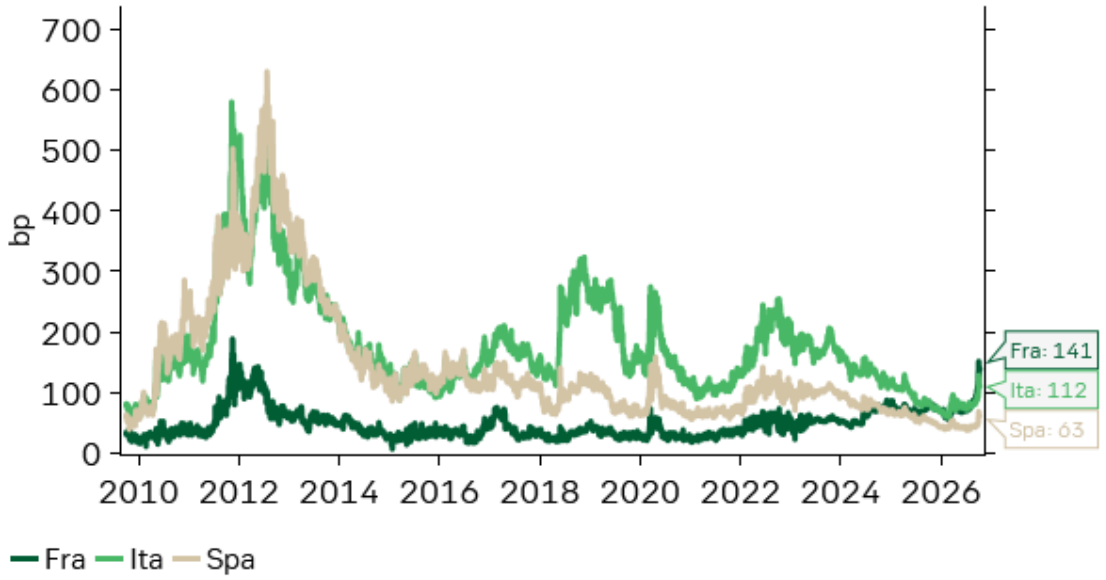
Forecasts. Links to SEB's official macro, central bank and financial forecasts.

Euro area fragmentation risk: How will the ECB respond?

France's OAT-led repricing has increasingly spilled over into broader EGB, credit and bank-funding markets since late September, fuelling concerns and reviving memories of the 2010-12 euro crisis. We do not expect a repeat: banks are stronger and the euro area now has a much more credible crisis-management architecture in place.

France becomes a market-wide risk factor. The initial shock was concentrated in OATs but has begun to extend beyond France, with broader EUR credit spreads also under upward pressure. The front-end widening of Italy-Germany spreads is also somewhat concerning and consistent with contagion from France, although German safe-haven demand and positioning may also be contributing. The availability of liquid short-dated BTP futures may have amplified the rapid spread widening.

10Y Government spreads vs. Germany (bp)



Source: Bloomberg, SEB

How will the ECB respond? Sovereign-spread widening does not automatically change the ECB's policy-rate reaction function. It will, however, probably make the ECB more cautious about the extent of further tightening and more attentive to the effective tightening already delivered through market rates.

Recent Governing Council (GC) comments underline the distinction between legitimate sovereign-risk repricing and unwarranted fragmentation. On 14 October, Šimkus stressed the importance of distinguishing between the two, while President Lagarde emphasised that the primary responsibility lies with French fiscal policy. Wunsch, meanwhile, noted that the ECB has the instruments needed to respond if developments become unwarranted. Separately, several prominent GC members, including Chief Economist Lane, have suggested over the past 1-2 weeks that tighter financial conditions resulting from higher market rates may reduce the need for further rate rises.

The threshold for ECB action may be crossed if spread moves become non-linear and self-reinforcing, impair market liquidity, transmit materially into bank funding and lending conditions, or cause financial conditions to diverge across member states beyond what country fundamentals justify.

Our expected ECB policy-response sequence. We consider the following sequence likely, beginning with communication and escalating to balance-sheet measures, bank-funding support and, ultimately, sovereign backstops. The sequence would also depend on the nature of the stress, and some measures could be deployed in parallel.

First, communication. The ECB emphasizes that it is monitoring monetary-policy transmission, collateral and funding-market conditions, and stands ready to use its instruments if needed.

Second, slowing balance sheet run-off. The ECB could temporarily resume reinvestment of maturing public-sector securities in its portfolios. In 2026, those maturities average around EUR 35bn per month. Beyond the direct market impact, the signalling value of such a decision could be significant.

Third, additional longer-term refinancing operations. The ECB could introduce longer-dated supplementary LTROs, with the 2011-12 three-year LTROs providing the closest precedent.

Fourth, TPI. The ECB could activate the Transmission Protection Instrument to address unwarranted and disorderly market dynamics before a sovereign enters a full financing programme.

Fifth, OMT. Outright Monetary Transactions would provide the sovereign-crisis backstop, subject to strict conditionality.

Will this be euro crisis 2.0? The current episode is primarily an OAT-led repricing of French fiscal and political risk. By contrast, the 2010-12 crisis featured acute sovereign-refinancing risk, fragile banking systems, impaired cross-border funding and rising redenomination risk.

Sustained OAT volatility could nevertheless spread through collateral and bank-funding channels and into wider EGB and credit spreads. The critical risk would be a shift towards non-linear, cross-border contagion that impairs market functioning.

Euro area banks are now better capitalised and more liquid, while the institutional architecture is stronger, including the ESM, TPI and OMT backstops. Those safeguards significantly reduce tail risks.

Operational framework review: a separate issue. The ECB is currently reviewing the operational framework announced in early 2024. We expect the review's findings in H1 2027, including further details on the longer-term structural refinancing operations and structural securities portfolio that the ECB plans to introduce. These instruments are intended to meet the banking system's structural liquidity needs rather than address the fragmentation risks discussed above.

Explainer: TPI and OMT

TPI (Transmission Protection Instrument). The ECB established the TPI in July 2022 to support the smooth transmission of monetary policy. Subject to eligibility criteria, it permits secondary-market purchases of securities issued in jurisdictions where financing conditions deteriorate beyond what country-specific fundamentals warrant, threatening monetary-policy transmission. Purchase volumes are not restricted ex ante. Purchases would focus principally on public-sector securities with residual maturities of one to ten years, although private-sector purchases may also be considered where appropriate. Activation is discretionary and requires a comprehensive GC assessment of market and transmission conditions, eligibility and proportionality.

France's status under the Excessive Deficit Procedure (EDP) does not automatically preclude TPI. The more significant obstacle would be an ECB assessment that the repricing reflects fiscal fundamentals rather than an unwarranted impairment of monetary-policy transmission. A more plausible TPI trigger would be cross-border contagion accompanied by impaired liquidity, bank-funding stress and an unjustified widening of peripheral financing conditions.

OMT (Outright Monetary Transactions). The ECB announced OMT in September 2012 as a secondary-market sovereign-purchase backstop to safeguard monetary-policy transmission and the singleness of monetary policy. OMT purchases have no ex-ante quantitative limit but are concentrated in sovereign bonds with residual maturities of one to three years. Unlike TPI, OMT requires strict and effective conditionality attached to an EFSF/ESM macroeconomic-adjustment or qualifying precautionary programme, including the possibility of EFSF/ESM primary-market purchases. Purchases remain

conditional on full programme compliance and an ECB monetary-policy judgement that they are warranted.

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